Part III - Administrative, Procedural, and Miscellaneous

Interim Guidance With Respect to the Application of Treas. Reg. §1.883-3

Notice 2006-43

SECTION I. PURPOSE

This notice announces that the Treasury Department (Treasury) and the Internal Revenue Service (IRS) will amend the regulations under section 883 of the Internal Revenue Code (Code) to provide guidance regarding the proper interpretation of §1.883-3(b) in light of the repeal of section 954(a)(4) and (f) (foreign base company shipping provisions) by section 415 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) ("AJCA"). Until such regulations are issued, taxpayers may rely on the rules set forth in this notice.

SECTION 2. BACKGROUND

.01 Section 883(a) and (c)

Section 883(a)(1) and (a)(2) of the Code generally provide that income from the international operation of ships or aircraft derived by a corporation organized in a foreign country shall be excluded from gross income and exempt from U.S. taxation if the foreign country in which such corporation is organized grants an equivalent exemption to corporations organized in the United States. Section 883(c)(1) provides

that the section 883(a)(1) and (2) exclusion will not apply if 50 percent or more of the value of the stock of the foreign corporation is owned by individuals who are not residents of a country that grants an equivalent exemption to U.S. corporations (the section 883(c)(1) limitation). Under section 883(c)(2), the section 883(c)(1) limitation does not apply to any foreign corporation that is a CFC. Under section 883(c)(3), the section 883(c)(1) limitation does not apply if the stock of the foreign corporation is primarily and regularly traded on an established securities market in the United States or in a foreign country that grants an equivalent exemption to U.S. corporations.

.02 Treasury Regulations under Section 883(a) and (c)

On August 26, 2003, Treasury and the IRS issued Treasury Decision 9087, 2003-2 C.B. 781. Treasury Decision 9087 included final regulations implementing section 883(a) and (c) and provided that the section 883(a)(1) and (2) exclusion is conditioned on the corporation satisfying certain stock ownership and related substantiation and reporting requirements.

Under § 1.883-3(a), a CFC satisfies the stock ownership requirement if it meets the “income inclusion test” of §1.883-3(b) and satisfies certain substantiation and reporting requirements. The income inclusion test requires that more than 50 percent of the CFC’s adjusted net foreign base company income (as defined in 1.954-1(d) and as increased or decreased by section 952(c)) derived from the international operation of ships or aircraft is includible in the gross income of one or more United States citizens, individual residents of the United States, or domestic corporations.

.03 AJCA Shipping Income Provisions

Section 415 of the AJCA eliminated foreign base company shipping income as a type of subpart F income, effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of the foreign corporations end. The legislative history to section 415 of the AJCA indicates that Congress believed the elimination of foreign base company shipping income as a type of subpart F income would provide "U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors." See H. Rep. No. 548, Part I, 108th Cong., 2nd Sess. 209 (2004).

Commentators requested guidance on the proper interpretation of §1.883-3(b) in light of the repeal of the foreign base company shipping provisions. Commentators also expressed concern that foreign corporations may no longer satisfy the income inclusion test if they no longer derive foreign base company shipping income from the international operation of their ships or aircraft as a result of the statutory amendments to sections 954(a)(4) and (f).

Section 423 of the AJCA delayed the applicability date of the final regulations under section 883(a) and (c) for one year, until taxable years beginning after September 24, 2004.

.04 T.D. 9218

On August 5, 2005, Treasury and the IRS issued T.D. 9218, 2005-37 I.R.B. 503, to conform the applicability date of the section 883(a) and (c) final regulations in light of section 423 of the AJCA. In the preamble to T.D. 9218, Treasury and the IRS also addressed the interpretation of the income inclusion test in light of the AJCA. The

preamble stated that the better interpretation of §1.883-3(b) is that a CFC that satisfied the income inclusion test prior to the effective date of the AJCA may continue to satisfy it after the effective date of the legislation, provided the CFC can demonstrate that had section 954(a)(4) and (f) of the Code not been repealed, more than 50 percent of its current earnings and profits derived from its international operation of ships or aircraft would have been attributable to amounts includible in the gross income of one or more U.S. citizens, individual residents of the United States or domestic corporations (pursuant to section 951(a)(1)(A) or another provision of the Code) for the taxable years of such persons in which the taxable year of the CFC ends. The preamble to T.D. 9218 stated that Treasury and the IRS would issue regulations to clarify the application of the income inclusion test and invited comments on the most appropriate way to accomplish this clarification consistent with the principles of the existing section 883 regulations and the AJCA.

Treasury and the IRS received a number of comments in response to T.D. 9218. Generally, commentators suggested that the test proposed in the preamble to T.D. 9218 was too complex because it required CFCs to calculate hypothetical amounts of subpart F income as though sections 954(a)(4) and (f) had not been repealed. Commentators proposed several alternative approaches they viewed as simpler than the approach described in T.D. 9218, including replacing the income inclusion test with a test that determines whether certain U.S. persons, who are not flow-through entities own, directly or indirectly, more than 50 percent of the value of the CFC for more than half of the days in the CFC's taxable year. Some commentators suggested that CFCs

organized in a foreign country that provides a reciprocal exemption to U.S. corporations on their income from the international operation of their ships or aircraft should be eligible for the exclusion under section 883(a)(1) and (2) without further limitation.

SECTION 3. NEW RULE: QUALIFIED U.S. PERSON OWNERSHIP TEST

Treasury and the IRS have considered the comments received in response to T.D. 9218. Treasury and the IRS continue to believe that residents of countries that do not provide a reciprocal exemption to U.S. corporations on their income from the international operation of their ships or aircraft might attempt to use the CFC exception to circumvent the rules of section 883(c)(1) by owning more than 50 percent of the value of a foreign corporation through a U.S. fiscally transparent entity, such as a U.S. partnership. Treasury and the IRS continue to believe that this is contrary to the Congressional intent to ensure that the exclusion provided in section 883(a)(1) and (2) is provided only to foreign corporations that are owned by residents of foreign countries that provide a reciprocal exemption to U.S. corporations. See S. Rep. No. 313, 99th Cong., 2nd Sess. 340-41 (1986); see also Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 927-928. In addition, Treasury and the IRS continue to believe this result is also contrary to the Conference report accompanying the legislation that added the CFC exception, which states that: "corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 598 (1986).

However, Treasury and the IRS agree that the income inclusion test, as it was

interpreted in T.D. 9218, is overly complex and unnecessary. As a result, based on the comments received and Congressional intent to increase the competitiveness of U.S. shippers through the elimination of foreign base company shipping income as a type of subpart F income, Treasury and the IRS intend to amend §1.883-3 to replace the income inclusion test with a new ownership based test. Under the new test, a foreign corporation will satisfy the stock ownership test of §1.883-1(c)(2) if it meets a "qualified U.S. person ownership test" and satisfies the substantiation and reporting requirements of paragraphs 1.883-3(c) and (d), respectively.

A foreign corporation shall satisfy the "qualified U.S. person ownership test" if, for more than half the days of the corporation's taxable year: (i) it is a CFC, and (ii) more than 50 percent of the total value of all the outstanding stock of the CFC is owned (within the meaning of section 958(a), as modified for purposes of applying this notice) by one or more "qualified U.S. persons."

A "qualified U.S. person" is a U.S. person (as defined in section 7701(a)(30)) that is a U.S. citizen, resident alien, or a domestic corporation. For purposes of applying the "qualified U.S. person ownership test," the value of the stock in the CFC that is owned (directly or indirectly) through bearer shares shall not be considered in the numerator or denominator of the ownership fraction. In addition, for purposes of applying this test, stock owned by a domestic partnership, domestic trust or domestic estate, shall be treated as owned by its partners, beneficiaries or owners, respectively, applying the rules of section 958(a) as if such domestic entity were a foreign partnership, foreign trust, or foreign estate, respectively.

SECTION 4. EFFECTIVE DATE

Regulations to be issued incorporating the guidance set forth in this notice will apply for taxable years beginning after the May 2, 2006. Taxpayers also may apply the provisions of this notice to taxable years beginning before May 2, 2006, but after December 31, 2004. Taxpayers applying this notice, however, must do so consistently for all taxable years for which this notice is applied and for which it is in effect.

SECTION 5. REQUEST FOR COMMENTS

Treasury and the IRS request further comments from interested persons on the rules announced in this notice. Written comments may be submitted to CC:INTL:Br1 (Notice 2006-XX), room 4607, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 5 pm to: CC:INTL:Br1 (Notice 2006-XX) Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC 20224. Alternatively, taxpayers may submit comments electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov.* Please include "Notice 2006-XX" in the subject line of any electronic communications.

DRAFTING INFORMATION

The principal author of this notice is Patricia A. Bray of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in its development. For further information regarding this notice contact Patricia A. Bray at (202) 622-3880 (not a toll-free call).